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Kaifu Gets High Marks For Summit Performance

Prime Minister Toshiki Kaifu generally received high marks from Japanese business leaders and ruling Liberal Democratic Party officials for his participation at the July 9-11 summit meeting of the seven major industrial nations. Specifically, the prime minister was lauded for upholding Japan's interests with respect to China and the Soviet Union. With an eye toward continuing protection of Japan's rice market, Mr. Kaifu also secured inclusion of a clause in the final communique stating that global negotiations aimed at liberalizing trade in agricultural products should "take into account [countries'] concerns about food security."

There are concerns in Tokyo, however, that as the December deadline approaches for conclusion of the Uruguay Round of multilateral trade talks, the prime minister no longer will be able to resist pressures from the United States and other trading partners to open up Japan's rice market. Thus, while Mr. Kaifu put in a commendable performance at the Houston, Texas meeting -- demonstrating to both domestic and international audiences that he has the leadership capabilities to hold his own with experienced heads of government -- the true test of his staying power will come later this year.

are waiting to see what role tax revenues from the U.S. subsidiaries of Japanese businesses will play in the U.S. budget problem.

Margo Grimm and Hideo Takahashi

Yen Recovers Some Lost Ground

Up, down or sideways? Currency traders in 1990 can be forgiven for not always being sure which direction the foreign exchange market is heading. By mid-July the yen was much stronger than it had been in April, when it bottomed out near Y160=$1.00 after zigzagging down since December 1988. On July 13 the yen closed in New York at Y148.15 after going up to Y146.6 during the day, the highest value it had reached since February. However, 1990 as a whole is shaping up as even worse for the yen than last year, when its average value declined to Y137.96, or 7.1 percent below 1988's all-time annual high of Y128.15. With less than half the year to go, the yen has yet to approach its 1989 average value, even temporarily.

The relative weakness of the Japanese currency is even greater when viewed in inflation-adjusted terms (see Table). At its three-year nominal low in April 1990 the Japanese currency was a mere 3.8 percent stronger than its 1985 average real value based on an International Monetary Fund measure of the real value of the yen. This result suggests that the yen had given up virtually all the real gains it made against the dollar between 1985 and 1988. Had the yen sunk below Y170, the Japanese currency would have been lower than any annual real level since 1982, when it reached a record low by this measure.

Nominal and Real Values of the Yen Against the Dollar, 1983-90

(average for the period)

	Nominal	Real*
1983	Y237.5	101.7
1984	237.5	102.7
1985	238.5	100.0
1986	168.5	121.0
1987	144.6	124.2
1988	128.2	133.2
1989	138.0	127.2
1990 January	145.1	114.3
February	145.5	113.1
March	153.1	108.4
April	158.5	103.8
May	153.5	n.a.
June	153.8	n.a.

*An index based on unit labor costs and nominal exchange rates weighted by disaggregated trade levels in manufactured goods in 1980 and set at 100 in 1985.

Source: International Monetary Fund and Nihon Keizai Shimbun

In real terms the Japanese currency in mid-July was still further from its all-time high than its record low. With inflation and productivity trends suggesting that an appreciation of the yen's nominal value is necessary just to maintain its real value, a move to around Y140=$1.00 would be required to restore the yen's real value to the pre-1985 annual high achieved in 1978. A bigger appreciation to under Y120=$1.00 would put the Japanese currency in its adjusted 1988 range.

Policy in Washington and Tokyo may be partly responsible for the yen's recent strength. Federal Reserve Board chairman Alan Greenspan admitted in mid-July that the Fed has moved recently to reduce interest rates in this country, although subsequent Fed pronouncements downplayed this apparent policy shift. The Bank of Japan has given absolutely no indication that it plans to follow the Fed's lead; if anything, BOJ may even tighten monetary policy beyond the moves it took this spring (see JEI Report No. 13B, March 30, 1990). Japan's central bank has managed to distill some bad news from generally favorable price reports. (Wholesale prices were actually lower in June 1990 than the year before.) It noted that the prices of services, which, as a labor-intensive activity, presumably reflect the much-feared labor shortage in Japan more than wholesale prices, have risen sharply in recent months. Partly for this reason, BOJ sees no reason to drop its guard against the perceived serious threat of inflation.

Taken together, BOJ and Fed actions suggest that the short-term interest rate gap on Euroyen and Eurodollar three-month instruments, which stood at a mere 0.6 percentage point in mid-July, could narrow even more. Should this happen, the yen can be expected to strengthen further against the dollar. At most, Japanese investors would have to pay a small interest rate penalty in exchange for the elimination of currency-exchange risks in keeping their funds at home; that would reduce the supply of yen on the foreign exchange market and the demand for dollars. Already some Japanese analysts worry that the virtual disappearance of the interest rate differential on yen and dollar instruments, coupled with an already rising yen, could precipitate a stampede toward the Japanese currency at the expense of the dollar. While these same analysts believe BOJ probably could rein in such movements, the twists and turns of the yen during the past five years have been enough to buck some of the most experienced riders.

Douglas Ostrom

Japanese Savings Remain At High Level

Two recent reports give weight to the general impression of Japanese individuals as world-class savers. The Bank of Japan's annual flow of funds report shows that households in Japan significantly increased the net supply of savings available to other domestic sectors and to overseas borrowers in 1989 from the scaled-back levels of 1987 and 1988 -- talk of Japan's falling personal savings rate notwithstanding (see Table). Nonfinancial businesses, which dramatically increased plant and equipment spending in the late 1980s, boosted their demand for funds from the rest of the economy last year. The foreign sector, where a negative number indicates a net flow to overseas investors, continued to decline in importance, reflecting the steady reduction since the mid-1980s in Japan's current account surplus.

Japan's Flow of Funds, 1983-89

(percent of nominal gross national product)

	1983	1984	1985	1986	1987	1988	1989
Nonfinancial Corporations	-3.0%	-1.7%	-1.9%	-1.3%	-2.2%	-4.6%	-6.9%
Households	10.3	9.8	9.8	10.2	7.9	7.6	9.3
Public Sector	-6.8	-5.8	-4.2	-4.2	-1.4	0.6	0.6
Overseas	-1.8	-2.8	-3.6	-4.3	-3.6	-2.8	-2.0

Notes: A positive figure indicates that the sector was a net supplier of funds to the remaining sectors.

Financial institutions are excluded.

Source: Bank of Japan

A second survey by the Management and Coordination Agency provided details of the composition of financial and nonfinancial assets in Japanese households. In 1989 the average household had savings of Y10.9 million ($72,667 at Y150=$1.00), 1.6 times the level of the previous survey in 1984. While savings held in the form of stocks and bonds grew faster than financial assets in general, securities still accounted for only 25.6 percent of the typical household's financial assets last year against 42 percent for time deposits and 22.2 percent for insurance.

While American households might be boggled by the ability of their Japanese counterparts to maintain such high levels of savings, they are likely to be far less impressed by what is in the average Japanese home. Certainly, Japanese and U.S. data support the notion that the two countries are among the world's wealthiest. For example, well over 90 percent of households in both countries have color television sets. Similarly, nearly every household in the two countries has one or more refrigerators, and large numbers have air conditioners. Like their American counterparts, Japanese households often own the newest gadgets turned out by the nation's electronics powerhouses; last year 17.5 percent had video cameras, up from 4.7 percent in 1984.

In some respects, however, American households appear to be much more affluent. While both groups of households generally have washing machines, for example, the typical Japanese appliance requires manual operation, as did machines that disappeared from U.S. homes a generation ago. Fully automatic machines were in only 35 percent of Japanese households in 1989, up from 28 percent in 1984 and 30 percent in 1979. Even the latest figures for automatic machines are roughly half the corresponding figures for the United States and West Germany.

In addition, the Management and Coordination Agency statistics show that cramped housing in Japan may be exacerbating some differences between Japanese

households and those in other industrialized countries. (For details of Japanese housing, see JEI Report No. 30A, August 4, 1989.) Beds and sofa beds were found in 47.3 percent of Japanese households in 1989, down from 50 percent five years earlier. Presumably Japanese families are finding that space in their crowded homes can be used more efficiently if they use Japanese-style bedding, which easily can be stored in a closet during the day, rather than bulkier Western-style beds. In short, the data in these surveys present a picture of the Japanese consumer with spending and savings patterns different from those in most industrialized countries -- and not necessarily converging toward those patterns.

Douglas Ostrom

Foreign Direct Investment In Japan Up And Down

Unlike the across-the-board growth shown for Japanese direct investment abroad (see JEI Report No. 23B, June 15, 1990), the figures on foreign direct investment in Japan for the year ending March 31, 1990 were mixed. Despite a 33.3 percent jump in the number of direct investments flowing into Japan in FY 1989, the value of investment fell 11.8 percent in dollar terms compared with the previous fiscal year. FY 1989 also saw an abrupt reversal of the division of investment between the manufacturing and the nonmanufacturing sectors.

For the first time in several years the amount of new foreign direct investment going into Japan declined in FY 1989, despite a generally weaker yen. According to Ministry of Finance data, foreigners added just under $2.9 billion to their holdings in Japan in FY 1989 compared with more than $3.2 billion in the April 1988-March 1989 period (see Table 1). The cumulative gross book value of foreign direct investment stood at more than $15.6 billion on March 31, 1990. The number of investments, in contrast, rose from 4,268 in FY 1988 to 5,688 in FY 1989. The average value of each investment, therefore, fell from $759,840 to $502,813. The decline could be a result of an increased number of smaller firms trying to establish a presence in Japan and/or a lack of large investments.

Table 1 also shows a surge in the borrowing (loans and bond issues) in FY 1989 to advance into Japan, although equity capital remained the dominant method of entry. Loans jumped from $667 million to $919 million or 32.1 percent of all investment. Equity capital fell from $2.6 billion in FY 1988 to $1.9 billion in FY 1989 but still financed 67.9 percent of all foreign inward investment. These data also underscore the trend toward smaller investments. The average value of an investment funded by an investor's own money fell from $608,121 in FY 1988 to $344,271 in FY 1989, while the corresponding figures for the borrowing category were $20.8 million and $18.4 million.

By country the United States remained the largest source of foreign direct investment in Japan at $1.6 billion, accounting for 57.4 percent of FY 1989's total value, well above its 54.7 percent share the previous year (see Table 2). U.S. investment followed the overall pattern: the number of investments rose (from 670 to 727), while their total value was down (off 7.4 percent).

Other investors changed their rankings for the most part. Switzerland, which held the number-two spot in FY 1988, changed places with the Netherlands,

Table 1: Trends in Foreign Direct Investment in Japan, FY 1951-FY 1989

(number of cases and millions of dollars)

Fiscal Year	Equity Capital		Loans and Bonds		Total	
	Cases	Amount	Cases	Amount	Cases	Amount
1951-80	8,826	$2,979	n.a.	n.a.	8,826	$2,979
1981	919	432	n.a.	n.a.	919	432
1982	1,052	749	n.a.	n.a.	1,052	749
1983	2,363	813	n.a.	n.a.	2,363	813
1984	3,685	493	n.a.	n.a.	3,685	493
1985	3,322	780	48	$150	3,370	930
1986	3,045	760	34	180	3,079	940
1987	3,912	1,453	34	761	3,946	2,214
1988	4,236	2,576	32	667	4,268	3,243
1989	5,638	1,941	50	919	5,688	2,860
Total	36,998	12,976	198	2,677	37,196	15,654

Source: Ministry of Finance

Table 2: Foreign Direct Investment in Japan by Country, FY 1988-FY 1989

(in millions of dollars)

	FY 1988			FY 1989			Cumulative March 31, 1990		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
United States	670	$1,774	54.7%	727	$1,642	57.4%	7,681	$7,910	50.5%
Canada	98	22	0.7	83	35	1.2	672	187	1.2
United Kingdom	447	112	3.5	495	81	2.8	3,226	599	3.8
West Germany	239	195	6.0	365	144	5.0	2,028	690	4.4
France	223	27	0.8	388	25	0.9	1,993	227	1.5
Switzerland	303	273	8.4	403	87	3.1	2,278	1,015	6.5
Netherlands	351	157	4.8	735	248	8.7	2,133	730	4.7
Other Europe	181	52	1.6	193	40	1.4	1,778	377	2.4
Hong Kong	386	44	1.4	445	63	2.2	4,011	453	2.9
Japan*	411	306	9.4	333	198	6.9	3,391	1,851	11.8
Other	959	280	8.6	1,521	297	10.4	8,005	1,615	10.3
Total	4,268	3,243	100.0	5,688	2,860	100.0	37,196	15,654	100.0

*Investments by Japanese firms with significant foreign participation.

Source: Ministry of Finance

which had been fourth-ranked. West Germany held on to third, although its 239 investments worth $195 million in FY 1988 formed 6 percent of the total, while its 365 investments valued at $144 million in FY 1989 were good for only a 5 percent share. Investment from the United Kingdom fell 27.7 percent in value, but the number of investments rose slightly from 447 to 495. Investment from Hong Kong grew in both value and number, the exact opposite of reinvestment by

existing Japanese subsidiaries of foreign firms, which dropped in both value and cases.

It is interesting to note that based on the number of investments the Netherlands actually outranked the United States (735 to 727) in FY 1989 and that the number of investments from "other" countries grew a sharp 58.6 percent. The country data show even more clearly the pattern of smaller investments as most countries registered a greater number of transactions but posted a decline in the total value. From this one can surmise that a presence in the Japanese market is becoming more essential to an increasing number of businesses around the globe.

An analysis by industry shows a startling shift in the balance between foreign direct investment in manufacturing compared to nonmanufacturing (see Table 3). The manufacturing sector attracted 74.8 percent of all foreign investment in FY 1988 but only 41 percent the following year. Consequently, the nonmanufacturing sector's share of the total value of annual investment rose from 25.2 percent to 59 percent. Sharp declines in investment in chemicals (down 59.4 percent), machinery (-53.3 percent) and food processing (-80 percent) were the main reasons manufacturing recorded a decline. Only the metals industry showed a significant gain (37.9 percent).

Table 3: Foreign Direct Investment in Japan by Industry, FY 1988-FY 1989

(in millions of dollars)

	FY 1988			FY 1989			Cumulative March 31, 1990		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
Manufacturing	1,715	$2,425	74.8%	2,066	$1,172	41.0%	16,754	$10,202	65.2%
Food	122	86	2.7	126	17	0.6	1,130	283	1.8
Textiles	16	1	0.0	13	0	0	171	51	0.3
Rubber and Leather	1	0	0.0	34	29	1.0	120	76	0.5
Chemicals	181	500	15.4	194	203	7.1	2,217	2,722	17.4
Petroleum	37	27	0.8	24	8	0.3	465	692	4.4
Nonmetallic Mineral Products	9	11	0.3	8	6	0.2	375	141	0.9
Metals	11	29	0.9	187	40	1.4	867	497	3.2
Machinery	1,103	1,732	53.4	1,093	808	28.3	9,388	5,370	34.3
Other	235	39	1.2	387	61	2.1	2,021	370	2.4
Nonmanufacturing	2,553	818	25.2	3,622	1,688	59.0	20,442	5,452	34.8
Construction	134	8	0.2	419	9	0.3	1,170	82	0.5
Real Estate	72	70	2.2	121	647	22.6	374	794	5.1
Commerce	1,177	454	14.0	1,710	544	19.0	10,821	2,213	14.1
Services	971	152	4.7	972	138	4.8	5,521	798	5.1
Transportation	36	2	0.1	149	47	1.7	419	127	0.8
Communications	33	40	1.2	14	23	0.8	100	127	0.8
Banking and Insurance	14	61	1.9	40	180	6.3	247	572	3.7
Other	116	31	1.0	197	100	3.5	1,790	739	4.7
Total	4,268	3,243	100.0	5,688	2,860	100.0	37,196	15,654	100.0

Note: Totals may not add up due to rounding.

Source: Ministry of Finance

Sharp increases in funds flowing into real estate (from $70 million to $647 million), commerce (from $454 million to $544 million), transportation (from $2 million to $47 million) and banking and insurance (from $61 million to $180 million) accounted for the nonmanufacturing sector's new dominance. Only investments in general services (from $152 million to $138 million) and communications (from $40 million to $23 million) showed sizable declines.

Some caveats to the data should be noted. The declining value of the yen between FY 1988 and FY 1989, particularly against the U.S. dollar and the West German mark, distorted the true picture. Against the dollar the yen fell to Y142.83 in FY 1989 from Y128.26 in FY 1988 and against the deutsche mark it dropped to Y84.78 from Y71.14. Moreover, the data are based on notifications to the Bank of Japan and the Ministry of Finance; the reported values may not have corresponded to actual transactions and some of the planned investments might have fallen through.

The strong rise in the number of investments indicates either greater interest in the Japanese market on the part of smaller firms and companies from a broader range of countries or a decline in the number of large investments compared to previous years. The data appear to point to a mix of both. It is too early to tell if the proliferation of smaller investments and the shift between manufacturing and nonmanufacturing mark the start of new patterns or are simply one-year aberrations.

Jon Choy

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.